

**Internal Revenue Service**  
**memorandum**

CC:TL-N-8511-91  
Brl:JDMacEachen

date: AUG 26 1991

to: District Counsel, Oklahoma City CC:OKL  
Attn: Glenn McLoughlin

from: Assistant Chief Counsel (Tax Litigation) CC:TL

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subject: [REDACTED] - Pre 90 Statutory Notice Review.

This is in response to your request for Tax Litigation Advice dated July 5, 1991, and confirms a telephone conversation of August 14, 1991.

ISSUE

Whether [REDACTED] OM 19160, I-381-78 (September 19, 1979) still represents office policy on the issue of whether unsevered natural gas constitutes an inventoriable good for purposes of Treas. Reg. § 1.451-5(c). 451.13-04

CONCLUSION

OM 19160 remains the position of the Service with regard to the conclusion that producers of natural gas should not be required to use inventories since unsevered natural gas is more in the nature of realty than merchandise and, per Rev. Rul. 69-536, 1969-2 C.B. 109, realty is not inventoriable. Accordingly, unsevered natural gas does not constitute an inventoriable good for purposes of Treas. Reg. § 1.451-5.

FACTS

[REDACTED], an accrual-basis taxpayer, received advance payments pursuant to a take-or-pay gas contract. The take-or-pay provision required the purchaser to make minimum payments to the taxpayer regardless of whether the purchaser actually takes delivery of the gas. A question has arisen concerning the timing of the inclusion of these advance payments.

ANALYSIS

I.R.C. § 451(a) provides the general rule that any item of gross income shall be included in gross income for the taxable year in which received by the taxpayer, unless, under the method of accounting used in computing taxable income, such amount is to be properly accounted for as of a different period.

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Treas. Reg. § 1.451-5 addresses the timing of advance payments received for goods to be provided in the future. An advance payment is defined as an amount received by an accrual-basis taxpayer pursuant to an agreement for the sale in a future taxable year of goods held by the taxpayer primarily for sale to customers in the ordinary course of its trade or business. Pursuant to Treas. Reg. § 1.451-5(b)(1)(ii) a taxpayer may defer the recognition of advance payments received for noninventoriable goods until such time as they are properly accrued under the taxpayer's method of accounting for tax purposes provided that such amounts are not included in the taxpayer's financial reports for an earlier year. If the taxpayer's method causes the advance payments to be accruable in an earlier year for financial purposes, then the taxpayer must accrue the payments into income in the tax year in which they are included in its financial reports. Thus, as a general matter, advance payments received for noninventoriable goods are includible in income in the taxable year in which they are includible for purposes of Generally Accepted Accounting Principles, i.e., on delivery.

The drafters of the regulation were concerned about the potential for abuse inherent in such a rule. In cases where the seller has received all or a substantial portion of the selling price, and the goods are completed and/or available for delivery, the seller is essentially a bailee of the goods. Thus, it was decided to limit the deferral period available in the case of inventoriable goods. See [REDACTED] OM 19995, I-233-85 (April 8, 1986) at pp. 4-11. <sup>1</sup> (copy attached)

Accordingly, Treas. Reg. § 1.451-5(c) provides that if goods are inventoriable, the taxpayer must include the advance payments in gross income by the end of the second taxable year following the year of receipt, rather than when the goods are actually delivered. Thus, if goods are inventoriable, advance payments are permitted a maximum deferral of two taxable years. However, if the goods are not inventoriable, advance payments may not be includible until the goods are actually delivered, resulting in a substantial deferral of income.

[REDACTED], OM 19160 I-318-78 (September 19, 1979), concludes that producers of natural gas are not required to use inventories. Producers hold unsevered natural gas which is more in the nature of realty than merchandise. See also Sabine Corp., OM 19635 I-203-82 (September 13, 1982). Compare prop. Treas. Reg. § 1.263A(f)-1(c)(2), 56 Fed. Reg. 40,825

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<sup>1</sup> We note that the payments at issue in OM 19995 were ultimately found to be deposits. See Commissioner v. Indianapolis Power and Light, 110 S. Ct. 589 (1990).

(August 16, 1991), indicating that for purposes of the interest capitalization rules, mines, wells and other natural deposits constitute real property. Real property is not inventoriable. See Rev. Rul. 69-536, 1969-2 C.B. 109, amplified by Rev. Rul. 86-149, 1986-2 C.B. 67.

Your inquiry arises because of the Service's treatment of certain severed gas known as line pack and cushion gas. The issue of whether severed natural gas is inventoriable was addressed in Rev. Rul. 68-620, 1968-2 C.B. 199. The ruling concludes that line pack gas (that volume of gas necessary to maintain pressure and effect constant flow in a pipeline) is merchandise in transit which must be included in inventory. See also Rev. Rul. 78-352, 1978-2 C.B. 168, reaching the same conclusion, and Transwestern Pipeline Co. v. United States, AOD 1809, CC-1990-025 (September 7, 1990), indicating that Counsel continues to defend the position that line pack gas must be included in inventory.<sup>2</sup>

Further, Rev. Rul. 75-233, 1975-1 C.B. 95, holds that the cost of nonrecoverable cushion gas (that volume of gas necessary to operate a gas storage field) is a capital expenditure subject to depreciation for tax purposes. The Service is presently reconsidering whether recoverable cushion gas is a nondepreciable capital expenditure, or is includible in inventory. The Service treated recoverable cushion gas as inventory in LTR 8917036 (January 31, 1989). But see Arkla Inc. v. United States, 765 F.2d 487 (5th Cir. 1985).

Both the line pack and the cushion gas issues deal with the treatment of gas in the hands of distributors, *i.e.*, gas which has been removed from the well. The distinction between the positions taken in the rulings and that taken in the OM's is that line pack and cushion gas is gas which has been severed from the realty of which it once was part, and is no longer treated as realty. Conversely, the gas discussed in OM's 19160 and 19635 has not been severed, and remains a part of the underlying realty. Realty is not inventoriable. Thus, unsevered natural gas is not an inventoriable good.

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<sup>2</sup> In Transwestern Pipeline Co. v. United States, 639 F.2d 679 (Ct. Cl. 1980) the court held that the line pack gas at issue was a depreciable capital asset since it found that the vast majority of the line pack was not recoverable.

If you have any questions, please contact John D. MacEachen  
at FTS 566-4189.

MARLENE GROSS

By: Gerald M. Horan  
GERALD M. HORAN  
Senior Technician Reviewer  
Branch No. 1  
Tax Litigation Division

Attachment: OM 19995